

Department of Water Resources Electric Power Fund Financial Statements

For the years ended June 30, 2005 and 2004



Department of Water Resources Electric Power Fund

Index

	Page
Report of Independent Auditors.....	1
Management’s Discussion and Analysis.....	3
Statements of Net Assets	12
Statements of Revenues, Expenses and Changes in Net Assets	13
Statements of Cash Flows	14
Notes to Financial Statements.....	15

Report of Independent Auditors

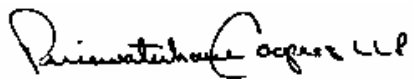
The Director of the State of California
Department of Water Resources

In our opinion, the accompanying statements of net assets and the related statements of revenues, expenses and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the Department of Water Resources Electric Power Fund (the Fund), a component unit of the State of California, at June 30, 2005 and 2004, and its changes in financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Fund's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, the financial statements of the Fund, are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2005 and 2004, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 31, 2005, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with laws, regulations, contracts and grant agreements and other matters for the year ended June 30, 2005. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis presented on pages 3 through 11 are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

A handwritten signature in black ink, appearing to read "Primatshank Cooper LLC". The signature is written in a cursive, flowing style.

October 31, 2005

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

USING THIS REPORT

This discussion and analysis is designed to assist the reader in focusing on significant financial issues and activities and to identify any significant changes in financial position of the Department of Water Resources Electric Power Fund (the Fund), which is administered by the California Department of Water Resources (DWR). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follows *Management's Discussion and Analysis*. This discussion and analysis and the financial statements do not relate to DWR's other governmental and proprietary funds.

The basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of revenues, expenses and changes in net assets, and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of the year-end date. The statement of revenues, expenses and changes in net assets presents all of the current year's revenues, expenses, and changes in net assets. The statement of cash flows reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities: operating, financing and investing. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund is required to follow accounting standards promulgated by the Governmental Accounting Standards Board.

HISTORY AND FINANCING

The Fund was established in January 2001 through legislation to assist mitigation of the effects of a statewide energy supply emergency. DWR has the authority to secure and retain title to power for resale to end use customers of the State's investor owned utilities (IOUs) under power supply contracts entered into prior to January 1, 2003. DWR is entitled to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, administrative expenses and reserves.

In November 2002, DWR completed the issuance of \$11.3 billion in revenue bonds. The proceeds of the bond issues, along with the cash and investments in the Fund, were used to repay the outstanding balance of a \$4.3 billion term loan from a financial consortium, repay \$6.2 billion in advances from the State's General Fund with interest, and establish separate accounts in the Fund as required by the Bond Indenture.

On January 1, 2003, DWR transitioned total responsibility for the purchase of short-term power (residual net short) to the IOUs. DWR also transferred the scheduling, dispatch, and certain other administrative functions for the long-term contracts to the IOUs. However, DWR retains the legal and financial responsibility for the contracts until such time as there is complete assignment of the contracts to the IOUs and release of DWR.

While responsible for procurement of the residual net short, DWR was required under the terms of the Bond Indenture to maintain a minimum Operating Account balance of \$1 billion. After DWR transitioned responsibility for the residual net short to the IOUs, the required minimum Operating

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

Account balance for calendar 2003 was reduced to \$348 million. In July 2003, based on the impact of the 1) ability to reduce reserves, 2) collection of past due amounts from PG&E, 3) increases in costs, and 4) greater than anticipated cash balances, DWR decreased its 2003 Revenue Requirement by \$1 billion. The California Public Utilities Commission (CPUC) ordered the implementation of the revised revenue requirement through bill credits to the customers of the IOUs in fiscal 2004.

STATEMENT OF NET ASSETS

The Fund's assets, liabilities and net assets as of June 30, are summarized as follows (in millions):

	2005	2004	2003
Long-term restricted cash and investments	\$ 1,482	\$ 1,522	\$ 1,704
Note receivable, net of current portion	-	104	-
Recoverable costs, net of current portion	7,356	7,745	7,568
Restricted cash and investments:			
Operating and priority contract accounts	1,387	1,320	1,261
Bond charge collection and bond charge payment accounts	570	539	385
Other investments	80	33	37
Recoverable costs, current portion	573	656	1,129
Other current assets	26	15	36
Total assets	<u>\$ 11,474</u>	<u>\$ 11,934</u>	<u>\$ 12,120</u>
Net assets	\$ -	\$ -	\$ -
Long-term debt, including current portion	10,982	11,414	11,636
Other current liabilities	492	520	484
Total capital and liabilities	<u>\$ 11,474</u>	<u>\$ 11,934</u>	<u>\$ 12,120</u>

Long-Term Restricted Cash and Investments

The \$40 million and \$182 million decreases in long-term restricted cash and investments during the years ended June 30, 2005 and 2004, respectively, occur solely in the Operating Reserve Account and are a function of reduced Operating Reserve requirements. The \$555 million and \$595 million balance in the Operating Reserve Account at June 30, 2005 and 2004, respectively, are determined in accordance with the bond indenture and are equal to twelve percent of projected annual operating expenses of the Fund for calendar year 2005 and 2004, respectively. There has been no change in the \$927 million balance of the Debt Service Reserve Account; however, during the year ended June 30, 2004, \$600 million of the amount on deposit in the Debt Service Reserve Account was reinvested from the State of California Pooled Money Investment Account to investment in four guaranteed investment contracts and one forward purchase agreement with a financial institutions. The \$500 million of guaranteed investment contracts mature in May 2022, and the forward purchase agreement matures in November 2005.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

Note Receivable

The \$104 million note receivable was established as a part of the energy settlement with El Paso Corporation in 2004, and represented the discounted value of a series of semi annual payments through 2024. In May 2005 El Paso Corporation exercised its option to prepay the discounted note receivable and all amounts owed were received by DWR.

Recoverable Costs, Net of Current Portion

Long-term recoverable costs consist of costs that are recoverable through future billings. The majority of the \$389 million decrease during 2005 is attributable to the \$409 million of Bond Charge revenue in excess of interest expense. The majority of the \$177 million increase during 2004 is attributable to the \$1 billion bill credit to the customers of the IOUs, offset by the \$378 million net amount of Bond Charge revenue in excess of interest expense, and \$248 million from unanticipated energy settlements.

Restricted Cash and Investments

The Operating and Priority Contract Accounts increased by \$67 million in 2005 as there was a net increase in cash and investments from normal operations, plus the transfer of \$40 million from the Operating Reserve Account in conjunction with the implementation of the 2005 revenue requirement. The same accounts had a net increase of \$59 million in 2004. The \$1 billion bill credit, net of the associated collection of \$539 million of past due amounts from Pacific Gas & Electric Company (PG&E) and the \$147 million transfer from the Operating Reserve, decreased the cash balance by approximately \$314 million. This net reduction was offset by the collection of \$182 million from energy settlements, an additional \$35 million in transfers from the Operating Reserve Account, and an increase from normal operations of \$156 million, attributable to marginal net revenue from the sale of more power than originally anticipated.

The Bond Charge Collection and Bond Charge Payment Accounts increased by \$31 million in 2005 reflecting lower than forecasted interest payments and in anticipation of the \$410 million principal payment due in May 2006. The same accounts increased by \$154 million in 2004 in anticipation of the \$388 million principal payment due in May 2005.

From the dates of issuance of the revenue bonds through June 30, 2005, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the Bond Indenture.

Other Investments

DWR purchases natural gas as fuel for the production of power under the terms of certain long-term power purchase contracts and maintains a brokerage account with a national brokerage firm in order to hedge natural gas costs. Assets in this account are classified as other investments on the Statements of Net Assets.

During 2005, the use of the brokerage account for hedging natural gas costs increased. At June 30, 2005, the account consists of money market obligations, US Treasury bills, and government bonds valued at \$46 million and financial futures and options valued at \$34 million. At June 30, 2005, DWR has open positions with an unrealized marked-to-market value increase of \$15 million reflected in the account balance. The balance of other investments at June 30, 2004 is comparable to that at June 30, 2003.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Recoverable Costs, Current Portion

The current portion of recoverable costs reflects billings to IOU customers that have not yet been collected and amounts due for surplus sales of energy and gas. The current portion of recoverable costs decreased by \$83 million in 2005. Less power was supplied to the market in the spring months of 2005 than in 2004 with the conclusion of a major supplier contract as of December 31, 2004. Also, the remittance rate for power supplied to customers declined in fiscal year 2005 in varying amounts from each IOU. The current portion of recoverable costs decreased \$473 million in 2004, primarily due to the collection of past due amounts owed by PG&E.

Long-Term Debt

The \$432 million and \$222 million decreases in long-term debt in 2005 and 2004, respectively, are attributable to \$388 million and \$180 million in revenue bond principal payments and \$44 million and \$42 million in amortization of premium in each of the two years, respectively.

Other Current Liabilities

Accounts payable at each year end is comparable and reflect one month's accrual for power purchases, as payments are normally made on the 20th of the month following purchase.

Accrued interest payable at each year end is comparable as there has been limited decrease during 2005 and 2004 in the principal amount of bonds outstanding, offset by increases in the interest rate for variable rate debt.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

The Fund's activities for the years ended June 30, are summarized as follows (in millions):

	2005	2004	2003
Revenues:			
Power charges	\$ 4,263	\$ 3,887	\$ 4,418
Surplus sales	451	421	99
Bond charges	845	800	407
Interest income	96	95	61
Total revenues	<u>5,655</u>	<u>5,203</u>	<u>4,985</u>
Expenses:			
Power purchases	4,965	5,146	4,517
Energy settlements	(191)	(248)	-
Interest expense	436	422	444
Other expenses	56	59	328
Recovery (deferral) of recoverable costs	389	(176)	(304)
Total expenses	<u>5,655</u>	<u>5,203</u>	<u>4,985</u>
Net income	-	-	-
Net assets, beginning of year	-	-	-
Net assets, end of year	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Power Charges

The cost of providing energy is recoverable primarily through power charges to IOU customers and certain customers of "direct access" Electric Service Providers (ESPs). Charges are determined by applying a CPUC adopted rate for each IOU service area to the megawatt hours of power delivered by DWR to each IOU's customers.

Power charges increased by \$376 million in 2005 as compared to 2004. The overall increase is attributable to recording the \$1 billion bill credit as a reduction in power charge revenue in fiscal 2004. If there had been no bill credit in fiscal 2004, power charges would have been \$4.887 billion. Excluding the bill credit, power charge revenues decreased by 13% in 2005 as compared to 2004. Even though the cost of power decreased by 4% in 2005, DWR was able to reduce its power charges by a greater amount as DWR received monies from energy settlements, thereby reducing the amount of power charges that needed to be billed to end use customers.

Power charges decreased by \$531 million in 2004 as compared to 2003. Again, the overall reduction is attributable to recording the \$1 billion bill credit as a reduction in power charge revenue in fiscal 2004. If there had been no bill credit in fiscal 2004, power charges would have been \$4.887 billion. After adjusting fiscal 2003 for the impact of the \$113 million rebate for the "20-20 Energy Rebate Program", 2004 power charges, excluding the bill credit, increased by 8% over 2003 power charges. This increase is attributable to a 13% increase in power delivered in 2004 as compared to 2003 and average lower remittance rates in 2004.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Surplus Sales

Since January 2003, DWR has received revenue from the sale of excess energy, based on DWR's pro-rata allocation of its share of energy provided to each IOU's service area to the total amount of energy provided by IOU generation in each respective IOU service area, and from the sale of surplus gas.

Surplus sales in 2005 are \$30 million greater than in 2004, as the rising price received for sales of excess energy offset lower volumes available to be sold after satisfying end-user demand in the IOU service territories. Average prices received for sales of surplus energy rose 14% over 2004 while total megawatt hours sold declined 8%. Sales of excess natural gas in 2005 also rose by 13%, reflecting overall rising natural gas prices.

Surplus sales in 2004 were \$322 million greater than in 2003. Prior to January 1, 2003, surplus energy was used to reduce the amount of residual net short energy purchased in the wholesale markets.

Bond Charges

Bond charges were established in November 2002, provide revenue for the payment of debt service on the revenue bonds and are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to all IOU customers and certain ESP customers. Bond charges for the years ended June 30, 2005, 2004 and 2003 were \$845 million, \$800 million, and \$407 million, respectively, and were adequate to meet all debt service requirements and maintain bond indenture required account balances in the Bond Charge Collection, Bond Charge Payment, and Debt Service Reserve Accounts.

Interest Income

Interest income for 2005 is comparable to 2004 and is attributable to increased rates received on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund (SMIF), a full year's interest on the Debt Service Reserve Account's \$600 million reinvestment from SMIF to guaranteed investment contracts and forward purchase agreement, less the one time interest earned in 2004 on amounts owed by PG&E. The \$34 million increase in interest income in 2004 is primarily attributable to the receipt of \$38 million for interest on past due amounts owed by PG&E, as ordered by a CPUC decision issued in January 2004.

Power Purchases

DWR power costs are \$181 million lower in 2005 than in 2004. While there was minimal change in the amount of power purchased, DWR experienced a 4% decrease in its costs, primarily due to the completion of a high priced contract in December 2004. Total costs for purchased power decreased by approximately \$325 million in 2005; however, gas purchases used in the production of power increased by \$144 million due to increased gas prices.

DWR power costs are \$629 million higher in 2004 than in 2003. This 14% increase reflects the 13% increase in energy volumes purchases during 2004 at marginally higher costs than in 2003. The increase in power purchased is attributable to 1) power from new plants coming on line under the terms of the original power contracts, 2) increased use of DWR dispatchable contracts by the IOUs because of more downtime for an IOU nuclear facility than was originally forecast, and 3) higher market clearing prices which lead to the additional use of DWR dispatchable contracts for sale in the wholesale market.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Energy Settlements

Energy settlements received, including those related to complex regulatory proceedings before the Federal Energy Regulatory Commission arising from events in California energy markets in 2001, are recorded as a decrease in operating expenses.

Energy settlements of \$191 million were recognized in 2005 and include \$99 million from Dynegy Inc., \$76 million from Mirant Corporation, and \$14 million from Duke Energy Corporation. Future revenues under these settlements are subject to conditions outlined in the underlying settlement and allocation agreements. DWR also recognized an additional \$2 million from the 2004 settlement with El Paso Corporation.

In 2004, under the terms of a settlement between various parties and El Paso Corporation, DWR received \$225 million. The remaining \$23 million earned in 2004 is attributable to settlements with two other companies.

Interest Expense

Interest expense in 2005 is \$14 million higher than in 2004 as the result of increased interest rates on variable rate debt. Interest expense in 2004 is \$22 million less than in 2003. This is expected as the bonds were outstanding for all 2004, while for a portion of 2003, interest expense includes the higher rates for the General Fund Advances and term loan.

Other Expenses

Administrative expenses decreased \$3 million in 2005 due primarily to a decrease in charges for services provided to the Power Supply Program by other State agencies. Administrative expenses are \$12 million less in 2004 than in 2003 as costs incurred for contract renegotiation and litigation decreased during the year, and the IOUs have assumed more administrative responsibilities for the contracts since the transition of the residual net short in January 2003.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Recovery (Deferral) of Recoverable Costs

The individual components of the recovery (deferral) of recoverable costs are as follows (in millions):

	2005	2004	2003
Operations	\$ (116)	\$ (649)	\$ (71)
Debt service and related costs	505	473	(233)
	<u>\$ 389</u>	<u>\$ (176)</u>	<u>\$ (304)</u>

Operations

In 2005 DWR was able to decrease power charges and still maintain operating funds that are in excess of the amount required by the bond indentures. The large deferral of recoverable costs in 2004 is primarily attributable to the \$1 billion bill credit. This is offset by the \$248 million of energy settlements and other revenue received in excess of the cost of purchased power and administrative expenses.

Debt Service and Related Costs

The 2005 recovery is anticipated and is attributable to the bond charges being sufficient to pay for interest expense and retire debt. In 2004, \$473 million of recovery is attributable to 1) a full year's collection of bond charges, 2) use of \$180 million of the bond charge proceeds to retire principal on debt, 2) and collection of bond charges in the Bond Charge Payment Account in anticipation of the May 2005 principal payment of \$388 million. In 2003, the net amount deferred consists of one time costs incurred for issuance of revenue bonds that were financed through bond proceeds.

FUTURE OPERATIONS

On August 31, 2005 the Governor introduced legislation that would establish a Department of Energy through the consolidation of the functions of several departments, commissions and offices that currently implement state energy programs. If the legislation were to be enacted, all of the powers, duties, responsibilities, rights, obligations, liabilities and jurisdiction of DWR under Division 27 of the California Water Code would be assumed by the Department of Energy.

DWR or its successor will administer the Fund until such time as the revenue bonds are completely retired. Revenue requirements for the repayment of the bonds will be determined at least annually and submitted to the CPUC for implementation. Under the terms of the rate agreement between the CPUC and DWR, the CPUC is required to set rates for the customers of the IOUs and ESPs such that the Fund will always have monies to pay the principal of and interest on the bonds and all other bond related costs when due.

DWR has the authority to administer all power supply contracts entered into before December 31, 2002, for the life of the contracts. Over 95% of the volume of power under contract expires by December 31, 2011 and the last of the contracts expires in 2017. Revenue requirements for the payment of energy purchased under the contracts will be determined at least annually and submitted to the CPUC. Under the terms of the rate agreement between the CPUC and DWR, the CPUC is required to implement power charges such that the Fund will receive necessary monies to meet its revenue requirements.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

The financial responsibility for the contracts may be transferred to the IOUs as part of a complete assignment of the contracts and release of DWR or its successor. However, there are a number of issues to be addressed, including IOU acceptance of the assignment and counterparty approval, before the contracts can be assigned.

Department of Water Resources Electric Power Fund**Statements of Net Assets****June 30, 2005 and 2004****(in millions)**

	2005	2004
Assets		
Long-term assets:		
Restricted cash and investments:		
Operating Reserve Account	\$ 555	\$ 595
Debt Service Reserve Account	927	927
Note receivable, net of current portion	-	104
Recoverable costs, net of current portion	7,356	7,745
Total long-term assets	<u>8,838</u>	<u>9,371</u>
Current assets:		
Restricted cash and investments:		
Operating and Priority Contract Accounts	1,387	1,320
Bond Charge Collection and		
Bond Charge Payment Accounts	570	539
Other investments	80	33
Recoverable costs, current portion	573	656
Interest receivable	26	15
Total current assets	<u>2,636</u>	<u>2,563</u>
Total assets	<u>\$ 11,474</u>	<u>\$ 11,934</u>
Capitalization and Liabilities		
Capitalization:		
Net assets	\$ -	\$ -
Long-term debt:		
Revenue bonds	10,529	10,982
Total capitalization	<u>10,529</u>	<u>10,982</u>
Current liabilities:		
Current portion of long-term debt	453	432
Accounts payable	424	452
Accrued interest payable	68	68
Total current liabilities	<u>945</u>	<u>952</u>
Commitments and Contingencies (Note 7)		
Total capitalization and liabilities	<u>\$ 11,474</u>	<u>\$ 11,934</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund
Statements of Revenues, Expenses and Changes in Net Assets
For the years ended June 30, 2005 and 2004

(in millions)

	2005	2004
Operating revenues:		
Power charges	\$ 4,263	\$ 3,887
Surplus sales	451	421
Total operating revenues	<u>4,714</u>	<u>4,308</u>
Operating expenses:		
Power purchases	4,965	5,146
Energy settlements	(191)	(248)
Administrative expenses	56	59
Deferral of recoverable operating costs	(116)	(649)
Total operating expenses	<u>4,714</u>	<u>4,308</u>
Income from operations	-	-
Bond charges	845	800
Interest income	96	95
Interest expense	(436)	(422)
Recovery of recoverable debt service and related costs	<u>(505)</u>	<u>(473)</u>
Net income	-	-
Net assets, beginning of year	-	-
Net assets, end of year	<u>\$ -</u>	<u>\$ -</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund**Statements of Cash Flows****For the years ended June 30, 2005 and 2004****(in millions)**

	2005	2004
Cash flows from operating income:		
Receipts:		
Power charges	\$ 4,339	\$ 4,457
Surplus sales	445	379
Energy settlements	306	133
Payments for power purchases and administrative expenses	(5,046)	(5,144)
Net cash provided by (used in) operating activities	44	(175)
Cash flows from non-capital financing activities:		
Receipt of bond charges	847	776
Bond payments	(388)	(180)
Interest payments	(480)	(465)
Net cash (used in) provided by non-capital financing activities	(21)	131
Cash flows from investing activities:		
Investments purchased	(50)	(20)
Interest received on investments	85	95
Net cash provided by investing activities	35	75
Net increase in cash and investments	58	31
Restricted cash and investments, beginning of year	3,381	3,350
Restricted cash and investments, end of year	\$ 3,439	\$ 3,381
Reconciliation of operating income to net cash provided by (used in) operating activities:		
Income from operations	\$ -	\$ -
Changes in net assets and liabilities to reconcile operating income to cash net provided by (used in) operations:		
Recoverable costs	72	(233)
Due from other funds	-	21
Accounts payable	(28)	37
Total adjustments	44	(175)
Net cash provided by (used in) operating activities	\$ 44	\$ (175)

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

1. Reporting Entity

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (the Fund), administered by DWR, was established in January 2001 through legislation adding Division 27 to the California Water Code (the Code).

DWR currently purchases power from wholesale suppliers under contracts entered into prior to January 1, 2003 for resale to ten million customers of Pacific Gas & Electric Company, Southern California Edison Company, and San Diego Gas & Electric Company (collectively referred to as the investor owned utilities or IOUs). The Code prohibits DWR from entering into new power purchase agreements, but allows DWR to enter into gas purchase contracts to provide fuel for power generation.

DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the California Public Utilities Commission (CPUC).

Under the terms of a rate agreement between DWR and the CPUC, the CPUC will implement DWR's determination of its revenue requirements by establishing customer rates that will meet DWR's revenue needs to insure the payment of debt service, power purchases, administrative expenses and changes in reserves.

2. Summary of Significant Accounting Policies

Basis of Presentation

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenses.

The financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2005 and 2004, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

Restricted Cash and Investments

Under the terms of the Bond Indenture separate restricted cash and investment accounts were established. The accounts and their purpose follow:

Power Charge Accounts:

- Operating Account: Power charges (see Revenues and Recoverable Costs) and miscellaneous revenue are deposited into the Operating Account. Monthly, funds are transferred to the Priority Contract Account as needed to make payments on priority contracts. Remaining monies are available for payment of all operating costs of the Fund other than priority contracts, debt service, and debt-related costs.
- Priority Contract Account: Priority contracts are those power purchase contracts that require monthly payment prior to any debt service payments. Monies in the Priority Contract Account are used to make scheduled payments on priority contracts. After the monthly transfer from the Operating Account on the fifth of the month, the Priority Contract Account is projected to have monies sufficient to make scheduled payments on priority contracts through the fifth of the following month.
- Operating Reserve Account: The Operating Reserve account must maintain a balance equal to the greater of (i) seven months of projected negative operating cash flows under a stress scenario, as defined, or (ii) twelve percent of projected annual operating expenses of the Fund, as defined.

Bond Charge Accounts:

- Bond Charge Collection Account: Bond charges (see Revenues and Recoverable Costs) are deposited into the Bond Charge Collection Account. Monthly, funds needed for debt service payments are transferred to the Bond Charge Payment Account.
- Bond Charge Payment Account: Monies in the Bond Charge Payment Account are used to pay debt service, swap payments and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection Account, the balance in the Bond Charge Payment Account must at least equal debt service, swap payments and fees estimated to accrue or be payable for the next succeeding three months.
- Debt Service Reserve Account: The Debt Service Reserve account is to be funded at all times with the amount of maximum aggregate annual debt service on all outstanding debt, including net scheduled swap payments.

Restricted cash and investments, for purposes of the statements of cash flows, include cash on hand and short-term investments, specifically deposits in the State of California Investment Pooled Money Investment Account-Surplus Money Investment Fund (SMIF) and certain long-term investments.

SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). Generally, the investments in PMIA are available for withdrawal on demand. The PMIA cash and investments are recorded at amortized cost, which approximates market. PMIA funds are on deposit

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

with the State's Centralized Treasury System and are managed in compliance with the California Government Code, described in Note 3 below.

Long term investments are held solely in the Debt Service Reserve Account by the bond co-trustee and consist of guaranteed investment contracts (GICs) and a U.S. government backed agency security in accordance with a forward purchase agreement (FPA). The GICs are carried at cost and the U.S. government backed agency security is carried at amortized cost.

Other Investments

The Fund maintains a brokerage account with a national brokerage firm in order to take positions in futures and options for the hedging of natural gas fuel costs. Natural gas future and option agreements are reported at fair value on the statement of net assets. DWR does not enter into natural gas futures and option agreements for trading purposes, but rather to take advantage of favorable pricing and to reduce fuel price volatility. The Fund is exposed to additional fuel price risk if the counterparties default or if the future or option agreements are terminated. The Fund's position underlying open natural gas future and option agreements totaled \$34 million and \$12 million at June 30, 2005 and 2004, respectively. It is possible that the market price before or at the specified time to purchase natural gas may be lower than the price at which the Fund is committed to buy. This would reduce the value of the contract. The Fund could sell the contract at a loss, or if it were to continue to hold the contract, the Fund may make a termination payment to the counterparty to cancel its obligation under the contract and then buy natural gas on the open market.

The brokerage firm requires that the Fund maintain a security deposit, which is invested in compliance with the California Government Code. These funds are invested in money market mutual funds and government bonds and are carried at fair value. The investment in money market mutual funds amounted to \$30 million and \$20 million at June 30, 2005 and 2004, respectively, and the investments in treasury bills and government bonds amounted to \$16 million and \$1 million at June 30, 2005 and 2004, respectively.

Revenues and Recoverable Costs

Customer charges are separated into two primary components, power charges and bond charges. Power charge revenues recover the cost of power purchases, administrative expenses and operating reserves and are recognized when energy provided by DWR is delivered to the IOU customers. Certain customers of "direct access" Electric Service Providers (ESPs) are assessed "cost responsibility surcharge" that is used by DWR for the same purposes as Power charge revenues. Bond charge revenues recover debt service, debt service reserves and other bond related costs and are recognized when energy provided by either DWR or the IOU, or an ESP, is delivered to IOU, or ESP, customers. Costs are recovered over the life of the bonds (2022) as determined by DWR's revenue requirement process.

During the year ended June 30, 2004, power charges were reduced by \$1 billion in the form of bill credits given to the customers of the IOUs through the CPUC's implementation of DWR's 2003 Supplemental Revenue Requirement. This reduction was based on the net impact of 1) the ability to reduce reserves as allowed under the Bond Indenture, 2) the receipt of cash for past due amounts being held in trust by PG&E, 3) increases in costs, and 4) a greater than anticipated Operating Account balance at January 1, 2003.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

Surplus sales represent DWR's 1) allocated portion of the IOUs total surplus energy sales and 2) the sale of gas not needed for the generation of power. The revenue from the sale of excess energy by the IOUs is shared on a pro-rata basis between DWR and the IOUs, based on the amount of energy provided by DWR relative to the total amount of energy provided from IOU generation in the individual IOU's service territory.

Amounts that have been earned but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings and collection of finalized energy settlements are recorded as long-term assets.

3. Restricted Cash and Investments

The State of California has a deposit policy for custodial credit risk. As of June 30, 2005, \$40 million of the Fund's cash deposits of \$62 million was exposed to custodial credit risk as follows:

Institution	Amount	Custodial Credit Risk
Prime Value Obligations Fund		
Institutional Shares	\$ 30	Insured
U.S. Bank	10	Uninsured and uncollateralized
	<u>\$ 40</u>	

As of June 30, 2005, the Fund had the following investments:

Investment	Maturity	Fair Value
State of California Pooled Money		
Investment Account - State Money		
Investment Fund	5.5 months average	\$ 2,807
Guaranteed investment contracts	May 1, 2022	500
Forward purchase agreement	November 1, 2005	100
Natural gas futures and options	3 months average	34
Other	5 year average	16
		<u>\$ 3,457</u>

Interest Rate Risk: In accordance with its investment policy, the State of California manages its exposure to declines in fair values by spreading investments over various maturities: U.S. Treasury securities, 5 years; federal agency securities, 5 years; bankers acceptances – domestic and foreign, 180 days; certificates of deposits, 5 years; collateralized time deposits, 5 years; commercial paper, 180 days; corporate bonds and notes, 5 years; repurchase agreements and reverse repurchase agreements, 1 year.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

Credit Risk: PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. These investments consist of U.S. government securities, securities of federally-sponsored agencies, U.S. corporate bonds, interest bearing time deposits in California banks, prime-rated commercial paper, bankers' acceptances, negotiable certificates of deposit, repurchase and reverse repurchase agreements. The PMIA policy limits the use of reverse repurchase agreements subject to limits of no more than 10% of PMIA. The PMIA does not invest in leveraged products or inverse floating rate securities. The PMIA is not rated.

The Fund's investments in the guaranteed investment contract and forward purchase agreement are rated as follows, by Standard & Poors (S&P) and Moody's, respectively, at June 30, 2005:

	Amount	S&P	Moody's
GIC Providers			
FSA	\$ 100	AAA	Aaa
XL Capital	150	AAA	Aaa
Royal Bank of Canada	100	AA-	Aa2
Sun America	150	AA+	Aa1
	<u>\$ 500</u>		
FPA Provider			
Merrill Lynch: FHLMC			
Discounted Notes	<u>\$ 100</u>	AAA	Aaa

Concentration of Credit Risk: The PMIA's concentration of credit risk is limited by spreading the investment mix over different investment types, credit ratings and issuers to minimize the impact any one industry, investment class, or institution can have on the PMIA portfolio.

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 3.0% and 1.5% at June 30, 2005 and 2004, respectively. For the years ended June 30, 2005 and 2004, interest earned on the deposit in PMIA was \$65 million and \$50 million, respectively.

Interest on the GICs is paid semi-annually at interest rates ranging from 5.2% to 5.5%. Interest earned on the GICs was \$26 million and \$3 million for the years ended June 30, 2005 and 2004, respectively. The GICs mature in 2022.

The FPA allows the revenue bond trustee to continuously reinvest funds in U.S. government or U.S. government agency securities through May 2022 to earn a minimum rate of return of 4.7%, as specified in the Reserve Fund Forward Purchase and Sale Agreement, dated May 1, 2004. The reinvested securities are to mature every six months. Interest earned on the FPA was \$5 million and \$1 million for the years ended June 30, 2005 and 2004, respectively.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the years ended June 30, 2005 and 2004:

	Revenue Bonds	Unamortized Premium	Total
Balance, June 30, 2003	\$ 11,264	\$ 372	\$ 11,636
Payments	(180)	-	(180)
Amortization of premium	-	(42)	(42)
Balance, June 30, 2004	11,084	330	11,414
Payments	(388)	-	(388)
Amortization of premium	-	(44)	(44)
Balance, June 30, 2005	10,696	286	10,982
Less current portion	410	43	453
	<u>\$ 10,286</u>	<u>\$ 243</u>	<u>\$ 10,529</u>

The revenue bonds, all of which except Series E are tax-exempt, consist of the following at June 30, 2005:

Series	Rates	Fiscal Year of Final maturity	Fiscal Year of First Call Date	Amount Outstanding
A	3.0-6.0%	2022	2012	\$ 6,196
B	Variable	2020	Callable	1,000
C	Variable	2022	Callable	2,750
D	Variable	2022	Callable	500
E	3.6-4.3%	2006	Not callable	250
				<u>10,696</u>
Plus unamortized bond premium				286
Less current maturities				<u>(453)</u>
				<u>\$ 10,529</u>

Series B and C are variable rate bonds and have daily and weekly rate reset modes, respectively, and Series D has 35-day auction periods. The variable rate bonds have a final stated maturity of 2022, but will be retired in sinking fund installments from fiscal 2007 to 2022. The interest rates for the variable debt for the year ended June 30, 2005 and 2004, ranged from 0.9% to 3.1% and from 0.4% to 1.4%, respectively.

Principal and interest payments are payable from bond charges. The Fund is subject to certain bond covenants, including establishing funding and expenditure requirements for several restricted cash

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

and investment accounts. The bonds are limited special obligations of the Fund. Neither the principal nor any interest thereon constitutes a debt of the State. The payment of principal and interest for Series B and \$1.75 billion of Series C bonds are paid from draws made under letters of credit. Draws made under the letters of credit are to be reimbursed on the same day by the Fund. There are no outstanding amounts on the letters of credit at June 30, 2005. The letters of credit expire in fiscal 2011. The Fund pays fees of 0.45% per annum on the stated amount of the letters of credit.

The remaining \$1 billion of Series C bonds is credit enhanced by bond insurance for the timely payment of principal and interest. Liquidity support for these variable rate bonds is provided by bank liquidity facilities. Any funds paid under the bond insurance facilities are immediately due and payable by the Fund. Bonds purchased under the initial liquidity facilities are required to be redeemed in equal installments over a five or seven year period. There are no outstanding amounts due under liquidity facilities at June 30, 2005. Three liquidity facilities backing \$400 million in Series C bonds expire in fiscal year 2011, and two liquidity facilities underlying \$600 million of Series C bonds expire in fiscal year 2012. The Fund pays fees of 0.22% to 0.28% per annum under the liquidity facilities.

Future payment requirements on the revenue bonds are as follows at June 30, 2005:

Fiscal Year	Principal	Interest ¹	Total
2006	\$ 410	\$ 433	\$ 843
2007	427	416	843
2008	449	396	845
2009	471	374	845
2010	495	354	849
2011-2015	2,898	1,411	4,309
2016-2020	3,768	681	4,449
2021-2022	1,778	86	1,864
	<u>\$ 10,696</u>	<u>\$ 4,151</u>	<u>\$ 14,847</u>

¹ Variable portion of interest cost calculated using the June 30, 2005 Bond Market Association Municipal Swap Index (BMA).

5. Interest Rate Swaps

DWR, on behalf of the Fund, entered into interest rate swap agreements with various counterparties to reduce variable interest rate risk. The swaps create a synthetic fixed rate for DWR. DWR has agreed to make fixed rate payments and receive floating rate payments on notional amounts equal to a portion of the principal amount of DWR's variable rate debt.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

The terms, fair values, and credit ratings of counterparties for the various swap agreements at June 30, 2005 are summarized in the following table:

Outstanding Notional Amount	Fixed Rate Paid by Fund	Variable Rate ¹ Received by Fund	Fair Value	Swap Termination Date	Counterparty Credit Rating		
					S&P	Moody's	Fitch
\$ 94	2.914%	67% of LIBOR	\$ (3)	May 1, 2011	AAA	Aaa	AAA
234	3.024%	67% of LIBOR	(6)	May 1, 2012	AAA	Aaa	AAA
200	3.405%	BMA	(3)	May 1, 2013	A+	Aa3	A+
100	3.405%	BMA	(1)	May 1, 2013	A+	Aa3	AA-
30	3.405%	BMA	-	May 1, 2013	A+	Aa3	AA-
194	3.204%	67% of LIBOR	(5)	May 1, 2014	AA-	Aa1	AA-
174	3.280%	67% of LIBOR	(9)	May 1, 2015	AAA	Aaa	AAA
202	3.342%	67% of LIBOR	(8)	May 1, 2016	AA	Aa2	AA
202	3.389%	67% of LIBOR	(9)	May 1, 2017	A+	Aa3	AA-
<u>\$ 1,430</u>			<u>\$ (44)</u>				

¹ One month U.S. Dollar London Interbank Offered Rate or Bond Market Association Municipal Swap Index

The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions in notional amounts that follow scheduled amortization of the associated debt.

Fair Value: The reported fair values from the table above were provided by the counterparties, using the par value, or marked-to-market, method.

Credit Risk: As of June 30, 2005, the Fund was not exposed to credit risk because the swaps had negative fair values. However, should interest rates increase and the fair values become positive, the Fund would be exposed to credit risk in the amount of the swaps' fair value. DWR has a total of nine swap agreements with six different counterparties. Three swaps, approximating 35 percent of the total notional value is with one counterparty with a credit rating of AAA/Aaa/AAA. Of the remaining swaps, two are held with a single counterparty, approximating 21 percent of the outstanding notional value. That counterparty has credit ratings of A+/Aa3/AA-. The remaining four swaps are with separate counterparties, all having A+/Aa3/A+ ratings or better.

Basis Risk: The Fund is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR (a taxable rate index). The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while DWR's floating receipts on the swaps are based on LIBOR, which is determined in the taxable market. Should the relationship between LIBOR and the tax-exempt market change and move to convergence, or should DWR's bonds trade at levels worse (higher in rate) in relation to the tax-exempt market, DWR's all-in costs would increase. As of June 30, 2005, the variable rate on DWR's hedged bonds ranged from 2.1% to 2.5%, while 67% of LIBOR received on the swap was equal to 2.2%.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

Termination Risk: DWR's swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract. In addition, the swap documents allow either party to terminate in the event of a significant loss of creditworthiness by the other party. DWR views such events to be remote at this time. If a termination were to occur, at the time of the termination, DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. The counterparty would be liable for any payment equal to the swap's fair value, if it had positive fair value at that time. In addition, a termination would mean that DWR's underlying floating rate bonds would no longer be hedged, and DWR would be exposed to floating rate risk, unless it entered into a new hedge following termination.

Rollover Risk: Since the swap agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt, there is no rollover risk associated with the swap agreements, other than in the event of a termination.

Swap Payments and Associated Debt: As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of June 30, 2005, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term were as follows:

Fiscal Year	Variable Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2006	\$ -	\$ 33	\$ 14	\$ 47
2007	-	33	14	47
2008	-	33	14	47
2009	-	33	14	47
2010	-	33	14	47
2011-2015	1,026	119	55	1,200
2016-2017	404	14	7	425
	<u>\$ 1,430</u>	<u>\$ 298</u>	<u>\$ 132</u>	<u>\$ 1,860</u>

6. Retirement Plan

Plan Description

The State of California is a member of the California Public Employees' Retirement System (PERS), an agent multiple-employer pension system that provides a contributory defined-benefit pension for substantially all State employees. DWR is included in the State Miscellaneous Category (Tier 1 and Tier 2) within PERS, thereby limiting the availability of certain DWR pension data. PERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including DWR, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies. Copies of PERS' comprehensive annual financial report may be obtained from their

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

executive office at 400 P Street, Sacramento, California 95814. The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon an employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require ten years of credited service. Employees who retire at or after age 50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivor benefit options which reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by state statute.

Annual Pension Cost

For the years ended June 30, 2005 and 2004, DWR's annual pension cost payable from the Fund and actual contribution allocated to the Fund based on the Fund's payroll costs approximated \$1 million.

7. Commitments and Contingencies

Litigation and Regulatory Proceedings

DWR is involved in lawsuits and regulatory proceedings that could impact power costs and future revenue requirements.

In July, 2001, the Federal Energy Regulatory Commission (FERC) initiated a proceeding to calculate refunds for inflated prices in the California Independent System Operator (CAISO) and California Power Exchange Corporation markets during 2000 and 2001. DWR purchased \$2.9 billion in energy to meet the CAISO's emergency needs during 2001. DWR is treated in the FERC refund proceeding as a seller of that energy to CAISO, and in May 2004, FERC issued an order requiring DWR to pay refunds on the \$2.9 billion in "sales" to the CAISO. The refund amount totals approximately \$2.2 billion on a gross basis, of which DWR could actually owe up to approximately \$150 million on a net basis, because DWR would be the primary recipient of the refunds FERC required DWR to pay. However, FERC also later ruled that, like all sellers, to the extent DWR could demonstrate that payment of the refunds would result in DWR's costs exceeding its revenues, DWR could request FERC to reduce the refunds that would be owed. DWR sold all energy to the CAISO at its cost of acquisition. In September 2005, DWR made a cost recovery filing to request such a reduction in its refund obligation. Also in September 2005, the Ninth Circuit Court of Appeals ruled that FERC could not require governmental entities such as DWR to pay refunds. Accordingly, DWR has two possible methods of eliminating its potential refund liability: (1) the cost recovery filing it has made with FERC; and (2) the claim, based on the Ninth Circuit's ruling, that FERC has no legal authority to order DWR to pay refunds. Should the Fund be required to pay any refunds as a result of this proceeding, the refunds would be recoverable from ratepayers through future revenue requirements.

There are a number of lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result. In one consolidated set of cases, the issue is whether and to what extent compensation is due from the State of California as a result of the State's commandeering of certain block forward contracts in early 2001. Certain market participants claim that they are entitled to damages in excess of \$1 billion, their estimation of the fair value of the block forward contracts at the time of commandeering. DWR paid approximately \$352 million for energy provided under the contracts, which expired in December 2001. Given the early state of the proceeding, it is not possible to predict or determine the outcome of this matter or to provide an estimate of any losses, if any, that may arise. However, management believes that the costs associated with this action will not have a material adverse effect on the Fund's financial position or liquidity. Should the Fund be determined

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

to be the source of moneys to pay any damages resulting from this litigation, those damages would be recoverable from ratepayers through future DWR revenue requirements.

Management believes that the existing lawsuits and regulatory proceedings will be resolved in the next fiscal year. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

Other Contingencies

The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes that any costs associated with such losses are recoverable from customers as part of DWR's revenue requirement.

Commitments

DWR has power purchase contracts that have remaining lives of up to twelve years. Payments under these contracts approximated \$3.7 billion and \$4.1 billion for fiscal 2005 and 2004, respectively.

The remaining amounts of fixed obligations under the contracts as of June 30, 2005, are as follows:

Fiscal Year	Fixed Obligation
2006	\$ 2,783
2007	2,525
2008	2,379
2009	2,238
2010	1,805
Thereafter	1,638
	<u>\$ 13,368</u>

In addition to the fixed costs there are variable costs under several of the contracts. Management projected as of June 30, 2005 that the amount of future fixed and variable obligations associated with long-term power purchase contracts would approximate \$24 billion. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

Most of the power purchase contracts qualify as normal purchases and normal sales under the provisions of Governmental Accounting Standards Board Technical Bulletin 2003-1 (GASB TB 03-1), Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets. As a result, market valuation and certain risk information are not required to be disclosed.

However, five contracts do not qualify as normal purchases and normal sales under the provisions of GASB TB 03-1 primarily resulting from either pricing terms that contain variables which are not clearly and closely related to the base energy price or the seller is not a generator of electricity. As a result, certain information regarding these power purchase contracts is required to be disclosed. The fair value of these five contracts at June 30, 2005 approximated \$(104) million, using forward market

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

prices discounted at DWR's internal cost of capital. These contracts, with a total capacity of 2,385 MWh, expire at various times, from December 2005 through December 2011.

8. Energy Settlements

DWR and other parties have entered into settlement agreements with various energy suppliers which resolve potential and alleged causes of action against suppliers for their part in alleged manipulation of natural gas and electricity commodity and transportation markets during the 2000 - 2001 California energy crisis.

A settlement agreement with El Paso Corporation and affiliates became effective in 2004. At that time DWR received \$160 million in cash payments, \$50 million of which related to a refund of 2004 power purchase costs and is reflected as a reduction of power purchase expense. DWR received the remaining \$116 million due under the settlement agreement in 2005 of which \$114 million was the collection of amounts receivable at June 30, 2005 and \$2 million was recognized as revenue in 2005.

Also during 2004, settlement agreements with El Paso Electric Company and Portland General Electric Company were completed in which DWR received \$15 million and \$6 million, respectively.

During 2005, settlements with Dynegy Inc., Mirant Corporation, and Duke Energy Corporation became effective and DWR received \$99 million, \$76 million, and \$14 million, respectively. Future revenues from these settlements are subject to conditions outlined in the underlying settlement and allocation agreements.

9. Related Party Transactions

The California State Teachers' Retirement System (STRS), which is part of the California state government, participates in two letters of credit with a financial institution. The total commitment underlying the STRS' participation approximates \$177 million and expires on October 30, 2010. There are no outstanding amounts on the letters of credit at June 30, 2005.

10. Subsequent Event

The Fund anticipates issuing \$2.59 billion of variable rate refunding bonds in December 2005 to refund approximately \$2.35 billion of current 2002 Series A Bonds. In anticipation of the refunding bond issue, on October 11, 2005 the Fund entered into interest-rate swap agreements to pay fixed rates of interest and receive floating rate payments. Certain swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled and/or anticipated reductions in the associated "bond payable" category. The swap agreements are expected to reduce interest-rate risk associated with the variable-rate refunding bonds to be issued by the Fund. The Fund is exposed to potential loss in the event that a swap counterparty is unable to perform under the terms of the agreement. However, the Fund does not anticipate nonperformance by any swap counterparty.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2005 and 2004

(in millions)

The terms and credit ratings for these swap agreements as of October 11, 2005 are summarized below:

Outstanding	Notional Amount	Fixed Rate Paid by Fund	Variable Rate ¹ Received by Fund	Swap Termination Date	Counterparty Credit Rating		
					S&P	Moody's	Fitch
\$	355	3.184%	66.5% of LIBOR	5/1/2015	AA-	Aa3	AA-
	486	3.228%	66.5% of LIBOR	5/1/2016	AA	Aa2	AA
	480	3.282%	66.5% of LIBOR	5/1/2017	AA-	Aa2	AA-
	514	3.331%	66.5% of LIBOR	5/1/2018	AA-	Aa3	AA-
	306	3.256%	64% of LIBOR	5/1/2020	AA-	Aa3	AA-
	453	3.325%	64% of LIBOR	5/1/2022	AA-	Aa2	AA
<u>\$ 2,594</u>							

¹ One month U.S. Dollar London Interbank Offered Rate